This record is a partial extract of the original cable. The full text of the original cable is not available.

021652Z Jul 04

UNCLAS SECTION 01 OF 02 GUATEMALA 001641

SIPDIS

SENSITIVE

TREASURY FOR OASIA: TOLUI AND PARODI

E.O. 12958: N/A
TAGS: EFIN ECON GT
SUBJECT: FISCAL PACKAGE PASSED: LESS THAN IDEAL, BUT PROGRESS NONETHELESS

¶1. (U) SUMMARY: The Guatemalan Congress passed on June 21 and 23 the Temporary and Extraordinary Tax to Support the Peace Agreements (IETAP), reforms to the Corporate Income Tax, and reforms to the Tax on the Distribution of Alcoholic Beverages. Reform of the value added and personal income taxes, and a new tax on bunker fuel, did not prosper. The new tax measures are expected to increase tax revenues by Q2,200 million, but this is insufficient to cover the projected gap in the 2004 budget if the government were to do everything it says it wants to do. The government can still reach its 2004 deficit target of 2 percent of GDP with continued austerity and improved collection plus deferral of big-ticket plans. END SUMMARY.

The Fiscal Proposal: Background

¶2. (U) The Fiscal Pact Technical Commission (FPTC) submitted a tax proposal to the executive at the end of April 2004 that included reforms to the income tax, a "Temporary and Extraordinary Tax to Support the Peace Agreements" (IETAP), reforms to the value added tax (IVA), a tax on the distribution of alcoholic beverages, and a tax on the distribution of bunker fuel. The key components of the package for revenue purposes were the income tax reforms, the IETAP (which essentially replaces the IEMA alternative minimum tax that was declared unconstitutional at the end of 2003), and reforms to the IVA to eliminate exemptions and, in theory, improve collection.

¶3. (U) The FPTC's intention was to broaden the tax base by reducing evasion, eliminating exemptions, and including more individual taxpayers by creating new tax brackets at lower income levels. A provision in the IVA reform called for large scale wholesalers and retailers to pay an extra three percent withholding tax on their purchases on the theory that it would encourage them to collect all taxes from sales to their customers to offset the extra amount withheld. A wide variety of civil society organizations protested the personal income tax reforms on grounds that the burden would fall on middle and low-income families. Low margin wholesalers and retailers protested vigorously that they could not cover the additional three percent IVA withholding through taxes collected from their customers and that the reform amounted to an interest-free forced loan to the government. The Chamber of Industries protested that the tax on bunker fuel would make several large companies uncompetitive. After consulting with social, labor, and business groups, Congress decided to exclude personal income tax, the IVA reforms and the new tax on bunker fuel tax.

Only Three Taxes Approved

¶4. (U) On June 21 and June 23, 2004, the Guatemalan Congress passed IETAP, reforms to the Corporate Income Tax, and reforms to the Tax on the Distribution of Alcoholic Beverages. The three taxes will enter into effect on July 1, 2004 (the beginning of the next tax year, which does not coincide with the government's Jan. 1 - Dec. 31 fiscal year). The IETAP will be a minimum tax on commercial, agricultural, and other juridical enterprises based on one fourth of net assets or one fourth of gross income, whichever is larger. It will be applicable for two and a half years, and the rates will gradually decline from 2.5 percent in 2004, to 1.25 percent in 2005 and 1.0 percent in
¶2006. Main reforms to the corporate income tax include the removal of the reinvestment allowance exemption and the establishment of new a fixed rate of 5 to 7 percent of gross income if companies chose not to apply the 31 percent rate on net income. The tax year for the income tax will be shifted from a January 1 -December 31 fiscal year beginning in 2005. Companies who continue to use the 31 percent rate on net income must comply with additional auditing requirements, which might discourage them from using this option. Companies that opt for the fixed rate on gross income will be exempted from paying the IETAP.

¶5. (U) The first draft of legislation made the IETAP the primary tax on income for businesses subject to it. Businesses would then reduce their corporate income tax liability by the amount of IETAP paid. EconCouns intervened with the Minister of Finance on behalf of the U.S. business community to allow the corporate income tax to be the primary tax, as the U.S. tax code would not recognize the IETAP as an eligible foreign income tax that could be credited against U.S. tax liabilities. We have not seen the final language, as it has not yet been published, but we believe the matter has been fixed.

¶6. (U) The Tax on the Distribution of Alcoholic Beverages establishes a rate of 6 percent on beer, 7.5 percent on wines and other fermented beverages and 8 percent on other alcoholic distilled beverages. The rate will be applied to the "suggested sales price" and not to the alcoholic content, as was originally proposed by the Executive. A member of the FPTC shared concerns that the suggested price might be subject to local influence peddling aimed at lowering the taxable value and that imported beverages could be adversely affected.

What is the Impact?

¶7. (U) The new taxes will provide additional resources to the government, but they will not be enough to cover the fiscal gap of the 2004 budget as initially presented by the Berger Administration. Early this year, the Finance Ministry had estimated a gap of Q9,717 million (Q8 = approx. $1), which would increase to Q13,713 million if other expenditures not considered in the 2004 Budget were added. With the fiscal proposal sent by the Executive to Congress, tax revenues were expected to increase by Q3,162 million in 2004. However, since reforms to the personal income tax and to the IVA were excluded, the revenue increase is estimated to be Q2,200 million, or 1.02 percent of GDP.

¶8. (U) The FPTC estimates that the Tax on Beverages will contribute around Q100 million, and the combined contribution of the IETAP and the corporate Income Tax reforms is expected to amount to Q1,300 million in 2004. The remaining Q800 million will be provided by administrative improvements carried out by the SAT. According to the FPTC, those Q800 million might also include part of the effect of the new fixed rate of the income tax, which was difficult to estimate separately from the IETAP.

¶9. (U) Congress also passed a law that authorizes the placement of Q4,400 million in government bonds, which added to the Q2,200 million that would be collected as a result of the new tax measures gives a Q6,600 million, which would be insufficient to cover the projected fiscal gap. Moreover, this amount does not include requirements to roll over maturing debt. The public sector deficit will need to be around Q3,300 million, or half of the amount to be raised through new taxes and bonds, if the government is to meet its target of a public sector deficit of 2 percent of GDP. That will require a combination of austerity and aggressive collection.

Comment

¶10. (SBU) The government's deficit projections have been intentionally alarmist as it pursued fiscal reform in an inexperienced and unfocused Congress that showed early signs of not necessarily wanting to cooperate. The government clearly hoped to make more progress than it did, but it made progress nonetheless. Income tax and IVA collections were up for the five months through May 2004, compared with the same months in 2003, and total revenues fell a modest 0.4 percent as IEMA collections dropped off sharply. The decline in IEMA collections alone was more than 13 times the decline in total revenues. The IETAPS will now replace what was lost with the IEMA, so there is every reason to expect collections for the full year to be better than last year. In short, the situation is not ideal, but continuing improvement in collections and austerity in government operating costs, together with deferral of some big-ticket items such as compensation for former militias (ex-PACS) suggest that an overall deficit target of 2 percent of GDP is still within the government's reach.

HAMILTON